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Edexcel Advanced GCE (A Level) Business

Paper 3: Investigating Business in a Competitive Environment

DETAILED INVESTIGATION (for teachers)

June 2018 Context

Chocolate Confectionery Market

SAMPLE MATERIAL

Minimising Workloads, Maximising Performance

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Changing Costs and Prices

General Introduction Including Possible Exam Questions

The cost of many of the raw materials used to make chocolate are subject to change, largely due to external, uncontrollable factors, ie factors outside producers' control, and many of these costs have increased in recent years. Exam questions may be based around these changes, requiring students to consider the **impact on manufacturers and / or prices**, as well as **possible strategies** manufacturers can take in response.

Highly useful information on changing costs and strategies chocolate confectionery manufacturers can take to reduce the impact of rising costs can be found on the following webpages: <https://www.hps-pigging.com/facing-challenges-in-the-chocolate-and-confectionery-industry/>; <https://www.hps-pigging.com/chocolate-production-staying-efficient-in-a-turbulent-market/>. Although these sources stem from the website of a UK based company, the information provided is applicable to manufacturers across the globe.

The Impact of Rising Raw Material Costs and Changes in Exchange Rates

One of the main factors affecting the price consumers pay for chocolate confectionery is the cost of the ingredients required to make it (eg cocoa powder and cocoa butter, sugar, milk, vanilla, nuts, etc), as well as the cost of energy (eg natural gas and fuel oil) required to power the manufacturing process. The last four years have seen the price of raw materials used by chocolate manufacturers, such as cocoa butter, sugar and vanilla rise sharply. Refer to the following extract:

Extract 45: The Rise in the Price of Commodities Used to Make Chocolate

Cocoa butter prices increased by almost 40% in 2016, on top of a progressive increase over the past four years. This was due to unfavourable weather conditions in cocoa producing countries as well as an increase in the global demand for chocolate.

The cost of producing milk chocolate also rose by 40%, due to steep increases in the price of sugar and whole milk powder.

The price of vanilla confectionery soared by nearly 150% in 2015. This was largely driven by poor quality harvests and lower quality beans.

(Sources: <https://www.hps-pigging.com/facing-challenges-in-the-chocolate-and-confectionery-industry/>; <https://www.theguardian.com/business/2016/nov/18/lighter-way-to-enjoy-maltesers-mars-shrinks-sharing-bags-by-15>)

The extract highlights how the price of a product is affected by the **availability of the product (supply)** in relation to the **demand** for the product. **If demand outstrips supply**, then **prices will rise**. It also highlights how the supply of commodities, such as cocoa is affected by **changes in the weather**. It is also affected by **political and civil unrest** in the regions in which it is grown. The majority is grown in Africa in the Ivory Coast and Ghana, where the use of child labour has also been exposed in recent years, and movements to eliminate this significant human rights issue, could also result in a shortage and / or an increase in price as farmers pay higher wages to adult labourers.

The **exchange rate** will also affect the price of **imported** raw materials and, for UK manufacturers; for example, the **weakening of the pound** has increased the cost of imported raw materials, including cocoa, sugar, nuts and vanilla.

Any increase in raw material costs **reduces profit** and, ultimately, the **return to shareholders**, unless a business can **increase prices** without **affecting sales** and / or **cut other costs**. Strategies manufacturers are using or could use to address the issue of rising raw material costs are considered below.

What strategies can be implemented to cope with rising costs?**Raise Prices**

Raising prices is a simple strategy, which could be implemented with minimum amount of cost. However, whether or not price can be raised depends on **price elasticity of demand**. This is largely affected by the nature of the product in question, ie whether it is a luxury or a necessity. Chocolate is generally considered to be a **'treat'** as opposed to a necessity, and so increasing price **risks falling sales**. A higher price might, however, be charged with a corresponding increase in quality (see below).

Premiumisation - Move Up-market

A chocolate manufacturer could consider **moving up market** and **'premiumising'** the chocolate produced. Previous sections have highlighted how there is **growing demand** for premium chocolate with a high cocoa content due to the potential health benefits, for which people may be willing to pay a higher price. Such a strategy could, therefore, help to **maintain profit margins**, when faced with the rising cost of raw materials. It would, however, incur some **one-off costs** eg in recipe reformulation, packaging design, branding and promotion, as well as, potentially, **higher ongoing costs** arising from the higher quantity of cocoa and / or other more expensive ingredients (and packaging materials).

Shrinkflation - Reduce Portion Size

An alternative strategy is to **reduce the size of a product, without changing the price**, ie 'shrinkflation'. This is a strategy that many of the global chocolate manufacturers have adopted. Refer to the Extract on **Nestlé, Marks and Cadbury** below.

Extract 46: Examples of 'Shrinkflation' by Nestlé, Mars and Cadbury

Nestlé have reduced the size of the Toblerone by 10% (from 400g to 360g) - with 11 peaks as opposed to 15 peaks, narrower triangles and larger spaces in between. Refer to the following brief video on this topic: <http://www.bbc.co.uk/news/av/business-37908692/ask-andy-what-is-shrinkflation>

Mars have also shrunk the size of their Malteser sharing bags by 15% - from 121g to 103g in weight. Mars and Snickers bars have also got smaller, and a six-pack of Cadbury's Creme Eggs has been whittled down to five. (Source: <https://www.theguardian.com/business/2016/nov/18/lighter-way-to-enjoy-maltesers-mars-shrinks-sharing-bags-by-15>)

Reducing the size of a product will incur some **'one-off' costs**, eg to **adjust machinery and packaging** (size and labelling eg weight). In the longer-term, it could help the business to **maintain profit margins**, as it requires **fewer quantities of ingredients**, and thus keeps down costs, whilst maintaining price. There is a risk, however, that loyal customers will feel **'short-changed'**, which could **negatively affect sales** and **overall profit**.

Reduce the Amount of Cocoa and Other Expensive Ingredients

Another option for chocolate manufacturers would be to **reduce the amount of cocoa and other expensive ingredients** used to make each product, whilst keeping prices the same. This could help to **maintain profit margins**. However, changing recipes, particularly long-standing ones, could not only incur **significant research and development costs**, but could also result in a **loss of loyal customers** and, thus, risks **falling sales** and **profit overall**.

Invest in New Technologies

When faced with the rising costs, a business may also seek to introduce new technologies to cut costs and improve the efficiency of the production process.

Specifically with regard to the issue of rising raw material costs, chocolate manufacturing companies could make full use of **liquid product recovery technology**, otherwise known as '**pigging**'. Information provided on the website of HPS, which claims to be world's leading specialist in such technology, states that its clients include '*multi-national, blue-chip companies such as Nestlé, Ghirardelli, Mondelēz and many others*'.

A detailed description of how pigging in general works can be accessed on the following webpages: <https://www.hps-pigging.com/about-hps/what-is-pigging/>; <https://www.hps-pigging.com/improving-confectionery-production/>. An overview of how pigging can improve chocolate production using the above sources is, however, provided below.

Extract 47: Use and Benefits of Pigging Technology for Chocolate Manufacturers

Pigging technology can enable a chocolate manufacture to **recover residual liquids** that remain in pipelines or tubing after liquid has been transferred from one location to another. Typically HPS systems recover up to 99.5% of residual product. By recovering liquid product that can be re-used in the manufacturing process this **increases output** and, thus, **potential revenues**, as well as **reduces waste** and, thus, **costs associated with processing waste**.

Pigging technology also helps to **clean** the inside of pipes and tubing. This is particularly important for chocolate manufacturers who produce a **range of products** with different ingredients, using the same equipment, and so need to clean pipes and tubing in between products to **avoid cross-contamination** of ingredients and, thus, help **ensure quality** and **reduce the chance of rework and the associated costs**.

Butter or oil is commonly used to aid the cleaning process in chocolate manufacture (as water does not work well with chocolate, especially chocolate with a high cocoa content). Unlike oil, butter is not reusable. Pigging can significantly **reduce or even eliminate the use of butter** to flush pipes and tubes altogether and can also **reduce the use of oil and other flushing products**. Pigging can, therefore, **reduce costs in terms of cleaning**.

Automated pigging systems reduce the need for labour to be used in the cleaning process, thereby **reducing labour costs**. They also help to **speed up the cleaning process**. This can help to **minimise downtime** between batches of products and, thus, **maximise productivity**.

The HPS website cites 15 potential benefits of hygienic pigging, as follows:

Extract 48: 15 Potential Benefits of Hygienic Pigging (for Businesses in General)

- Increased Profits, Productivity and Efficiency
- High Return on Investment (ROI)
- Increased Product Yields
- Lower Labour Costs
- Less Downtime
- Reduced Waste Processing and Transport Costs
- Lower Cleaning Costs
- Faster Changeovers
- Reduced Water Usage
- Increased product quality and reduced cross-contamination risks
- More consistent output and lower rework
- Better control over raw material and finished product inventory
- Higher capacity and increased flexibility through reduced number of processing lines
- Positive Environmental Impact and Improved Sustainability
- Smaller Carbon Footprint

A more detailed explanation of each of these benefits can be accessed here: <https://www.hps-pigging.com/about-hps/benefits-of-pigging/>. The website also provides access to a case study on how pigging recently helped '*one of the world's best-known nutrition, health and wellness companies*', with '*a rich history going back over 150 years*', and '*today has a wide range of businesses, a large number of brands and a diverse range of products*'.

Based on this description this is likely to be Nestlé, whose history dates back to 1866. HPS states that it had implemented product recovery and pigging solutions at some of the company's other facilities, including factories in the UK, US and Brazil. This case study can be accessed here: <https://www.hps-pigging.com/casestudies/pigging-confectionery-manufacture-case-study/>.

There is obviously a **cost to purchase and install** such technology but, as a result of the numerous benefits relating to increasing yields, productivity and efficiency, pigging systems can **generate a high return on investment**. The **payback** time is also **short**. The HPS site states that '*Typically, if you choose an HPS pigging solution, your savings will pay back the initial cost of the system in less than one year*'. A short payback period would **minimise the cost and risk** associated with the investment, especially if financed through bank borrowing (which incurs interest charges and has to be paid back at an agreed date).

Invest in Improving Sustainability in the Supply of Raw Materials

Although the price of cocoa and sugar is expected to fall back a little over the next year or two from their current high levels, longer-term, demand could outstrip supply due to climate change. Refer to the following Extract written by Katy Barnato and Luke Graham, published on the **CNBC** website on the 24 March 2016:

Extract 49: Prices to fall?

Hamish Smith, commodities economist at Capital Economics, also expects prices to fall. "After the recent surges in the prices of cocoa and sugar, we think that prices are likely to fall back a little from currently high levels". However... "While lower prices can be expected to benefit producers in terms of cheaper production costs, raw commodity costs tend to be a relatively small share of overall costs of goods such as chocolate (other costs include labour, transport, packaging and marketing)."

Longer-term, the supply-demand balance could shift, with cocoa production potentially challenged by climate change. Cocoa is a delicate crop and trees are susceptible to changing weather patterns, as well as diseases and insects. The International Center for Tropical Agriculture has warned that an expected annual temperature rise of more than 2 degrees Celsius by 2050 will leave many of West Africa's cocoa-producing areas too hot to grow the crop. Trees are seen struggling to obtain enough water during the growing season.

Some farmers in Ghana and Ivory Coast are already switching to more lucrative crops like palm oil or rubber. The Earth Security Group, a sustainability consulting firm, says that if farmers continue to switch out of the crop at the same rate, the world could face a 1 million ton cocoa shortage by 2020 — confounding forecasts of excess supply.

(Source: <https://www.cnbc.com/2016/03/24/future-of-the-chocolate-industry-looks-sticky.html>)

President of **Mars Chocolate UK**, Fiona Dawson, in 2012, emphasised the need for chocolate to be manufactured **more efficiently and sustainably** and for the industry to **work more closely with farmers** so they can adopt **more sustainable practices**. It refers to **greater adoption of certification schemes**, such as **Fairtrade** and **Rainforest alliance**, to ensure best practices encouraged. (Source: <https://www.foodmanufacture.co.uk/Article/2012/06/13/Mars-Chocolate-warns-action-on-cocoa-needed-to-beat-shortage>)

Many of the leading global chocolate confectionery manufacturers, including **Mars** have done much to encourage more sustainable cocoa farming - as highlighted in the section on CSR above. Over the last 10 years, this has included investment in developing cocoa varieties that are '*higher yielding, more robust and resistant to drought and disease*'. (Source: <http://www.mars.com/china/about-us/history>) This not only **helps farmers to earn a better living**, but helps ensure **continuity of supply**, which is important in **keeping down the price** of cocoa and, thus, helps to keep down **raw material costs** for manufacturers like Mars, as well as **portraying Mars in a positive light** from a CSR perspective, which (as explained in the section on CSR) can also be **commercially beneficial**.

Subsidies for fertilisers to help **increase yields** could also help **keep down raw material costs** - this is explained further in a later sub-section below.

Other Costs

The above extract ('Prices to fall?') highlights how **raw materials costs** tend to be a **relatively small share** of the **overall costs** of a chocolate manufacturer, with other costs including **labour, transport, packaging and marketing**. In order to be as competitive on price and maximise profits and the return to shareholders, a business needs to seek to be as **efficient** as possible in all of these areas.

The Impact of Changes in Government Subsidies (Political Influences)

The majority of the world's supply of cocoa comes from Cote d'Ivoire, Ghana and Indonesia. Nigeria, Cameroon, Brazil and Ecuador are also significant in terms of global cocoa production but supplying far less than these top 3 countries. (Source: <https://www.worldatlas.com/articles/top-10-cocoa-producing-countries.html>) Government subsidies within these countries can play a significant part in sustaining the global supply of cocoa. For example, the **government of Ghana** has recently (2017) agreed to subsidise cocoa fertilizer. Refer to the following extract published on the Ghana Cocoa Board website on 5 June 2017:

Extract 50: COCOA FERTILIZER SUBSIDY GHANA

The Chief Executive of Ghana Cocoa Board (COCOBOD), Hon. Joseph Boahen Aidoo has indicated that the new policy on cocoa fertilizer subsidy is very important for the sustenance of the cocoa industry. Giving highlights during a discussion programme on Oman FM, a private radio station in Accra, Hon. Aidoo said under the new fertilizer subsidy policy, government is offering granular fertilizer at GH¢80.00 per bag. This represents 53.4% of the current average price of GH¢171.75. He also noted that foliar (liquid) fertilizer will be sold to farmers at GH¢20.00 per litre constituting a subsidy of 81.03% of the current average price of GH¢105.00 per litre. According to Hon. Aidoo, the subsidy will create equitable access and prevent the smuggling of cocoa fertilizer to neighbouring countries.

(Source: https://cocobod.gh/news_details/id/114/COCOA%20FERTILIZER%20SUBSIDY.%20BEST%20FOR%20COCOA%20INDUSTRY%20-COCOBOD%20CHIEF)

Government subsidies with regard to cocoa production could help **aid continuity of supply** and **keep down the cost of cocoa** and, thus, ultimately, **the cost of raw materials** for chocolate manufacturers (and, in turn, prices for consumers).

Government subsidies can also be important in **maintaining chocolate production and competitiveness in overseas markets** and the removal of such subsidies could have a significant impact. For instance, since the introduction of '**The Chocolate Law**' in 1974, Swiss companies, including **Nestlé** and **Lindt**, have received state **compensations** for the products they **export**, due to the **high price of Swiss agricultural goods, such as milk and wheat**; the cost of these raw materials can be **two to three times the cost of foreign competitors**. (Custom duties have also helped to curtail cheaper foreign imports). The amount of these food subsidies is open for debate each year. Refer to the following extract by Matthew Allen, published on SWI webpages on 15 Dec 2016:

Extract 51: The Phasing Out of 'Chocolate Law' Subsidy Payments in Switzerland

Between 2010 and 2014 'The Chocolate Law' subsidy payments made by the Swiss government to Swiss companies that export, were around CHF70 million each year, but this rose to around CHF95 million in 2015. In 2016, the Swiss government wanted to cut expenditure and recommended a return to CHF70 million. Intense lobbying prevented this cut. This success is, however, to be short lived, as pressure from the World Trade Organisation (WTO) has forced the Swiss government to agree to phase out the subsidy completely by 2020. To make matters worse, a 'Swiss Made' law came into force on 1 January 2017 which compels manufacturers to use local ingredients if they want to use the prestigious 'Made in Switzerland' label.

(Adapted from: https://www.swissinfo.ch/eng/powerful-lobby_-chocolate-law-subsidy-stays-sweet-for-food-manufacturers/42765972)

Removal of, or any reduction in the subsidy would **increase the cost of raw materials** for companies such as **Nestlé** and **Lindt**. Nestlé and Lindt could **raise prices** in order to **protect margins** but this would make them **less competitive** in **world markets**, which could **reduce sales**. Alternatively, they may be able to **absorb the increase** in raw material costs, thereby **reducing profit margins** and, ultimately, the **return to shareholders**. They could also consider **importing raw materials eg milk from overseas** but, as the article points out, they would then not be able to use the '**Made in Switzerland**' label, and this could have a **significant, negative effect on sales**.

The Impact of Taxes on High Calorie, Fat or Sugar Products (Political Influences)

A recent article in confectionery news, which can be accessed from here: <https://www.confectionerynews.com/Article/2016/11/04/Taxation-significant-impact-on-future-chocolate-sales>, and refers to research by Euromonitor, highlights how many countries are considering, or have already implemented taxes on high calorie, fat or sugar products. For example, in 2014 **Mexico** set a tax on high calorie food and beverages with added sugars in order to reduce obesity growth. This included **an 8% tax on chocolate** (as well as other sugary foods). Such taxes inflate the price of chocolate which could have a **significant impact on chocolate sales** - at least in **the short-term**. In the article on confectionery news, analyst from Euromonitor, Jackie Skelly, stated that in the year Mexico introduced a calorie tax **volume growth declined by 3 percent**.

The Impact of Changing Prices

In general, if the price of a product rises the demand for the product falls and, vice versa, if the price of a product falls, the demand for the product rises. However, this depends on the sensitivity of customers / consumers to changes in price ie price elasticity of demand (PED).

Remember, PED is a measurement of the extent to which the demand for a particular product changes in response to a change in price. It is calculated by dividing the percentage change in quantity demanded by the percentage change in price.

A **price elastic product** is said to have an **elasticity of greater than 1**, meaning that the percentage change in demand is greater than the percentage change in price and customers are said to be price-sensitive. Where **elasticity is less than 1**, the product is **price inelastic** and customers are said to be **price-insensitive**.

The extent to which customers / consumers are sensitive to changes in price, essentially depends on the following:

- **The nature of the product – The extent to which the product is regarded as a necessity, or is habit forming.** If the product is considered to be essential for survival eg bread and water, or is habit forming eg drugs, alcohol, tobacco, then demand is unlikely to be affected by a change in price.
- **The availability of substitutes ie similar products.** Customers are more likely to be sensitive to changes in price where close substitutes exist and it is relatively easy for them to purchase an alternative product. The impact of a price change on demand will depend upon customers' **individual perceptions**, preferences and tastes. Customer perceptions and preferences can, in turn, be influenced by promotion, in particular, **branding, packaging and advertising**.
- **The price of the product as a proportion of income.** Products / services that only cost a small proportion of income eg a packet of sweets, a car wash, are likely to be less sensitive to changes in price and, thus, to be price inelastic compared to those that cost a large proportion of income eg a car, a family package holiday.

In the case of chocolate confectionery, if the imposition of taxes and / or the rising cost of raw ingredients such as cocoa and sugar, force manufacturers, and as a result retailers, to put up prices, then this could **reduce the global demand for chocolate** and, thus, **sales**, especially if **alternative cheaper 'treats' or snacks are available** which consumers regard as **close substitutes**.

Evaluative comment: It should be appreciated, however, that the impact on demand and, thus, the level of sales of manufacturers arising from a rise (or fall) in price **will vary between consumers in different geographical markets as a result of differences in levels of income**. Consumers in emerging markets, such as India, for example, are likely to be far more sensitive to changes in price, as the price of chocolate is, in general, likely to represent a higher proportion of income than it does for consumers in developed economies, such as North America and Europe. The confectionery news article cited in the previous sub-section refers to 13 countries that are considering taxes, which includes France, the UK and India and points out that a calorie tax could deter sales in emerging economies, such as India, where **consumption is more linked to gross domestic product (GDP)**.

It should also be appreciated that although chocolate is generally regarded as a 'treat' and more of a luxury than a necessity, given that **it contains phenylethylamine (PEA)**, which, as highlighted at the very beginning of this companion, can **make you feel good and enhance your mood**, people might become **emotionally attached** to it, **reducing their sensitivity to changes in price**.

In addition, significant research has also been undertaken (and publicised) which has determined **significant health benefits of dark chocolate**, with a cocoa percentage of around **70% or more** (if eaten in moderation), namely that it can **help in the prevention of cardiovascular diseases (CVD), some forms of cancer, diabetes**, as well as **memory loss in older people**. If this research is **widely publicised and promoted** to consumers, this might also make people regard chocolate as more of a **staple product to include regularly in their diet**, ie more of a necessity as opposed to a luxury. In which case, this would also **reduce their sensitivity to changes in price**. (However, it could further increase the demand for cocoa, resulting in a rise in price of this commodity and an increase in the cost of this particular raw ingredient for chocolate manufacturers!).

(Note: Information on the health benefits of chocolate were provided towards the beginning of this companion in the section entitled 'Some General Facts About Chocolate', which cited the following source: <http://www.telegraph.co.uk/health-fitness/nutrition/chocolate-10-health-reasons-you-should-eat-more-of-it/>)